If the free market model is to work more effectively in the banking industry, argues PROFESSOR TED GARDENER, banking institutions have to be marked out as special.

The question "Are banks special?" was the most fundamental one raised by the 2007 financial crisis.

If banks are "special", what does this mean for how they should be regulated; their corporate governance arrangements; and the required standards of professionalism expected of bankers?

We could argue that banks are special because they are more heavily regulated than other firms and several bank-type regulations (like capital adequacy) are atypical for banking.

We could also argue that banks are special because of the "too big to fail" doctrine – the big banks were bailed out by the state during the recent financial crisis. We could also observe that when the banking system retrenches, the real economy suffers badly too.

All these observations suggest banks are special, yet they still do not explain exactly why they are special.

One view of banks is that they are the most important economic institution developed in modern history because of their ability to transmute deposits into loans and investments which contributes strongly to economic growth and stability.

Basel 3, for example, recognises transparently this macro role of banks via the new countercyclical capital-adequacy rules.

On the flip side though, banks are one of the most dangerous economic institutions because of their periodic contribution and exposure to systemic risk events. The "specialness" of banks is bound up with this conundrum.

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In modern economic thinking, there has been a move away from the idea that banks are special. It is in the field of regulation that the debate has been most heated, especially since the 1970s and particularly in the US.

A primary economic aim of banking regulations (like prudential capital adequacy and liquidity rules) is to help reduce the incidence and impact of systemic risk events that could mutate into a financial crisis. Since financial crisis are exceptional disturbances in financial markets, it's critical to explore relevant historical experiences in order to understand why they happened and whether this kind of event can be mitigated in the future.

The 1930s banking crisis associated with the US Great Depression was the most severe banking crisis before 2007, and it also had some noteworthy similarities. For example, it produced a kind of free market experiment in banking, since the political philosophy of the day was laissez-faire. As a result, when banks began to fail in ever larger numbers and in successive waves, the central bank did not step in immediately to provide lender of last resort liquidity. It was from these experiences that some of the important principles of modern central banking were learned the hard way.

These events also led to modern capital adequacy rules (including stress testing) and techniques like deposit insurance being developed. Bank deposit insurance is unique because a primary aim is to help prevent the event (deposit runs) by helping to bolster confidence in the banking system.

The Glass-Steagall Act 1933 (which effectively separated retail and investment banking) also came directly from these experiences. It took over half a century to repeal Glass-Steagall and then the 2007 financial crisis to resurrect these same "ring fencing" questions.

From the 1970s, banks in many countries have been strongly deregulated. The alleged omnipotence of the external market as the best allocator of banking resources was enshrined in Basel 2, since the underlying philosophy of was to converge "economic" and "regulatory" bank capital. In practice, this meant giving the capital market a greater role in setting bank capital levels.

Basel 3, though, has re-asserted the importance of regulatory capital, where regulators have the final say about how much systemic, risk-cushioning capital adequacy is needed.

An underlying thread that runs through this background is that banks are apparently special because they borrow short and lend longer. This fundamental economic process helps to develop and sustain an economy via the increased lending and investing generated. But in doing this, banks are exposed to a liquidity risk – the more they lend, the greater this risk. Banks should always be prudent in running their risks, but history has shown that additional measures are also needed.

With these additional measures, a kind of "social contract" emerges. Banks can earn higher profits and may be protected from the downside when things go badly wrong because of these additional, state-provided supports. As a result, the state also has to protect itself (i.e taxpayers) via regulatory requirements like prudential supervision.

If the free market model is to work more effectively in the banking industry, this implicit social contract has to be recognised. One way of addressing it is to require new corporate governance rules for banks that would encompass senior bankers and bank directors becoming more responsible for those kinds of imprudent actions that can help to produce systemic shocks. At the same time, there has to be a return to recognising banking as a profession with wider economic responsibilities.

Recognising and handling these underlying realities may facilitate a more robust capital -market discipline on banks' resource allocation strategies. As a result, the deregulation model may help generate the benefits of greater competition, but without the attendant costs of periodic financial crises. CB

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